TESTIMONY

BASEL II:

Policy Issues in Complex Proposal Warrant Congressional Scrutiny

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It is an honor to appear today before this Subcommittee to discuss the potential ramifications of the international risk-based capital rules under consideration in Basel for U.S. financial institutions and – even more important – for the economy that depends upon them. I am managing partner of Federal Financial Analytics, a consulting firm that advises a range of financial services firms on U.S. legislative, regulatory and policy issues affecting their strategic planning. In this capacity, we advise a variety of companies on the implications of specific sections of the Basel proposal. We also advise the Financial Guardian Group, which represents those U.S. banks most concerned with the proposed operational risk-based capital charge.

Today, I would like to highlight:

- the need for a common-sense solution to the problems the revised Basel rules aim to fix. This means quick action on agreed-upon flaws that increase risk, and conservative and cautious action on the more complex problems where solutions could have unintended and costly consequences;
- the importance of the Basel Accord. Despite its complexity, these rules drive bank profitability in lines of business like mortgage and small-business lending, so they will have a direct impact on credit availability and macroeconomic performance;
- the need to get credit risk-based capital right, regardless of the final capital requirement imposed on individual banks. Now, Basel thinks 8% is the right number. In fact, banks with low-risk portfolios should hold far less capital and those with higher-risk books can and should hold more. Efforts to plug the rule to keep the capital number constant will continue the "regulatory arbitrage" problem Basel negotiators aimed to fix when they first sat down at their table more than five years ago;
- the importance of getting the Basel rules right for U.S. banks, which are subject to strict supervisory penalties including closure if capital falls below the "prompt corrective action" targets;
- the critical nature of effective supervision. Despite including a supervisory section ("Pillar 2") in the draft Accord, Basel is increasingly focused on capital numbers and not on improving supervisory standards at home and abroad. International capital standards cannot on their own resolve safety-and-soundness problems, as the experience in Japan makes clear; and
- the unique nature of the U.S. financial services industry and the laws under which it operates, which make wholesale implementation of Basel standards problematic. Of particular concern to U.S. banks is the competitive impact of the proposal, given that the rules will not apply to non-banking firms that are major players in the U.S. financial market, as well as the fact that foreign regulators may implement the standards quite differently and adversely affect

the U.S. position in global trade in financial services. Resolution of which U.S. banks the rules will apply and what version will be implemented is essential to addressing additional competitiveness concerns, as well as ensuring that regional financial markets remain well served. The potentially very high cost of Basel II exacerbates these concerns. Cautious implementation is also warranted by the fact that the rules could heighten market booms and worsen busts ("procyclicality").

I should like to emphasize that this statement is not in any way opposed to much of what is proposed in the most recent version of Basel II. Indeed, some of it is so good and so important that I think it should be immediately implemented. However, I fear that other aspects of the complex rule could have unintended consequences, and these should be approached cautiously after the keystones of the current proposal are put in place.

The Cost of Complexity

Economists and financial analysts at regulatory agencies around the world have spent literally thousands of hours working to revise the risk-based capital standards that govern internationally-active banks around the world and all insured depositories in the United States. This effort is an important one because flaws in the first set of capital rules (often called Basel I) have led to undue risk-taking and other concerns that warrant immediate attention. Much of the work to build Basel II is very sophisticated, with elaborate computer models of complex financial simulations driving many aspects of the new standards. Financial markets are now complex, so risk-based capital must be as well. However, at the outset of my statement I would like to mention the work of economists far from the Basel deliberations whose simple and clear guideposts should assist both the final Basel deliberations and Congressional review of them.

Herbert Simon, a Nobel Prize winning economist detailed the importance of "maximization" in making hard decisions like those facing the Basel committee. Quite simply, maximization is not letting the best drive out the good. It's making small decisions based on the facts at hand, avoiding "sunk costs" in sweeping decisions that can have profound, unintended consequences. Organization theorists call this concept "incrementalism" or, less grandiosely, "muddling through." Again, the lesson is to do the best you can with what you know and defer efforts to fix everything everywhere in every way – "synoptic" solutions – to limit unintended and adverse effects.

In my opinion, Basel negotiators have become enmeshed with a sweeping, synoptic solution to the known problems in the current rules. In so doing, they have deferred action on the egregious problems in Basel I that in part, led to the Asian collapse in 1998 and, now, to the credit risk problems at large banks in the wake of Enron, WorldCom, *et al.* Similarly, supervisory action on major emerging risks – operational ones, for example – has been deferred. In fact, the solution to these known and relatively easy-to-fix problems has been postponed at least until January 1, 2007.

Another risk with synoptic solutions such as the one Basel now seeks is the problem of finally implementing them. Regulators are already fearful that they will lack both the knowledge and person-power to review the complicated models banks must have to take advantage of the credit risk internal ratings-based and the operational risk advanced measurement approaches. Without these resources and skills, regulators may well slow the ability of banks to take advantage of these sophisticated models and even thwart them by inappropriate restrictions or mistaken sanctions. Real-world supervisory limits add still more force to arguments for a less ambitious rule that first does what regulators know they can do in areas of clear concern and only then moves on to more difficult tasks.

Why Capital Counts

Before moving on to a discussion of specific issues raised by the current Basel draft, I would like to spend some time on why whatever happens at Basel matters so much in each of your districts – and not only to the banks there, but also to those who rely on banks for a safe place to put their money and a constant source of funding for mortgages, businesses and overall economic development. It's all too easy to get caught up by the hundreds – indeed almost a thousand – pages of the Basel draft and lose sight of what the point of this exercise is or – even harder – why it matters outside the arcane circle of model-builders buried deep in the proposal's details.

Quite simply, regulatory capital is a key driver of bank profitability. Banks – like all other companies – measure profitability on return on equity – that is, how much can a shareholder get if he or she invests in Bank A versus Bank B or Automaker Y or all the other places money can go. For unregulated firms, capital required to bear risk is determined by what the market demands. Banks of course must look to market demands for capital – so-called "economic capital" – but regulators also set capital based on their view of the risk of an asset (e.g., a loan). When economic and regulatory capital numbers differ, regulators win and the bank must hold whatever amount of risk-based capital the regulator dictates to remain in business.

Differences between economic and regulatory capital are among the most important strategic drivers of bank decision-making. When regulatory capital is lower than economic capital, an incentive for the bank to take risk is created because the bank can effectively hold that risk at higher profit than firms subject to the market's demands. This is among the reasons why banks have gone into subprime lending in such a big way in recent years. The crude nature of the Basel I capital requirements imposes a maximum 8% risk-based capital (RBC) charge on assets ranging from short-term bonds offered by AAA-rated companies to portfolios of loans made to people who have gone bust a time or two. The regulatory capital numbers make it unprofitable for the bank to hold low-risk assets (driving them out into the broader market that now dominates in this area), while at the same time making it more profitable – even on a risk-adjusted basis – to take on more speculative assets.

Regulators call this "regulatory arbitrage" – meaning that bankers have figured out how to maximize profit by exploiting the inadequacies in the current capital standards. Quite simply, the capital rules have a perverse incentive: they encourage banks to hold high-risk assets and sell low-risk ones into capital markets. Basel II began in large part to curb this regulatory arbitrage, and this remains a driving reason for quick action on many aspects of the proposed rules.

Remaining Risk of Regulatory Arbitrage

As noted, Basel II is primarily an effort to eliminate the undue risk-taking that resulted from the crude assignment of RBC in Basel I. However, as regulators seek the synoptic complete new rewrite of risk-based capital, they at the same time appear fearful of the result, which can and should be a drop – perhaps a big one – for banks with low-risk positions. As a result, regulators are attempting to hedge their bets in the complete rewrite of RBC by limiting the ability of banks to take advantage of the massive rewrite once it is finally in place. This strategy means not only that immediate improvements in Basel are unduly put off, as discussed above, but also that the underlying problem in Basel I will remain even after Basel II goes live.

Several of the concessions regulators have made as they try to get a comprehensive new capital rule are particularly problematic from an arbitrage point of view. Of course, all negotiations require compromise, but one as far-reaching as the Basel Accord can result in trade-offs with unintended and undesired consequences. Again, had Basel II focused immediately on the problems in Basel I on which virtually everyone is agreed, these potentially serious adverse consequences would have been avoided. In this regard, I would draw particular attention to the treatment of small- and medium-sized enterprises (SMEs), the proposed operational risk-based capital (ORBC) requirement, and ongoing problems deciding how to recognize credit risk mitigation (CRM).

Before going into detail on these, however, I would like to note that the arbitrage problem is also compounded by the reluctance of regulators – especially those in the European Union – to let banks take full advantage of potential reductions from the changed credit risk rules. The current draft permits banks to drop capital only 10% below current standards in the first year (2007) Basel II is in place and then only 20% below current capital rules in the second year and, perhaps, for an uncertain period thereafter. However, banks subject to an increase in capital will have to boost capital on January 1, 2007, putting all of the cost – but little of the anticipated Basel benefits – on the back of the industry even as it wrestles with the complexity and cost of the revisions.

Specific Arbitrage Problems

Let me talk briefly about specific sections of the Basel II proposal that highlight the arbitrage problem and point to the need for quick action on a smaller-scale rewrite of the international RBC standards.

Treatment of Small- and Medium-Sized Enterprises

I would like to note first the low capital requirements for SMEs in the current draft. Of course, small business is a deserving and very important segment of the economy. I know; I run one. However, SMEs as defined in Basel are firms with annual revenues of up to \$50 million – far larger than the ventures we normally consider small businesses in the U.S. Under Basel II, SMEs would be treated either the same as loans to individuals (i.e., retail credit) if the business is small or at terms far more favorable than larger companies in the overall treatment of commercial credit.

However, SMEs are generally far riskier than big companies. Many are start-ups, with all the risks attendant thereto, and most are not tracked by external ratings agencies or others providing banks with an objective credit risk assessment. They also often are not of a size to warrant full-scope credit risk monitoring, so that problems at small companies can go unnoticed by their banks until bankruptcy looms. Assigning the SME charge too low, as Basel has done, creates a regulatory incentive for banks to divert funds into SMEs, based on the fact that banks can arbitrage this low regulatory capital against other lenders who must set aside appropriate economic capital. This may sound like a good idea, especially in the U.S. where we like small businesses. However, we here have a range of tax incentives and even a Small Business Administration designed to ensure an ongoing supply of funds to risky small businesses without creating a threat to the deposit insurance system.

Why this favorable SME capital treatment? Simple – German Chancellor Schroeder last year threatened to take Germany out of the Basel negotiations – stopping them cold – unless U.S. and U.K. negotiators bowed to this capital charge. Germany lacks U.S.-style government agencies supporting small business, and the medium-sized ones are particularly critical to that nation's economy (and, apparently, its hard-fought election last year).

2. Operational Risk

Even as U.S. negotiators were conceding to Germany on the SME question, they last year also made big concessions to Germany and other EU nations on the operational risk-based capital front. This testimony will not go into depth on ORBC, as another witness will do so. However, it is critical to note the potential regulatory arbitrage that may result from the proposed ORBC charge. Each of the proposed approaches to ORBC – including the advanced measurement one – will result in regulatory capital considerably higher than economic capital due to the reliance on gross income, the failure to scale the capital charge and the lack of recognition of proven forms of operational risk mitigation. As a

result, the ORBC charge will induce undue risk-taking – banks will comply with the regulatory capital charge instead of undertaking costly risk mitigation – putting the financial system at undue risk.

3. Credit Risk Mitigation

One of the major arbitrage problems in Basel I at which Basel II is aimed is the current failure of the capital rules to recognize credit risk mitigation – loan insurance, collateral and similar proven ways others stand between lenders and loss. Regulators are hesitant to recognize CRM fully because not all forms of it work all the time. However, some types of CRM have a proven history of absorbing large amounts of credit risk without disputes or counterparty failures. Quick action to recognize these forms of CRM will create an appropriate incentive for CRM – an incentive regulators should clearly make a top priority due to the relative simplicity of doing so.

Mistakes in Basel Can Have a Big Impact on U.S. Banks

Getting RBC right is particularly important in the United States, where federal law and implementing rules mandate a range of serious sanctions when regulatory capital falls. These sanctions were mandated by Congress in 1991 after the S&L debacle of the 1980s and serious problems in the commercial banking sector emptied the federal deposit insurance coffers and cost taxpayers at least \$250 billion. The FDIC Improvement Act of 1991 introduced "prompt corrective action" (PCA), under which sanctions are imposed as an insured depository falls below the "adequately-capitalized" level. If capital falls to the "critical" level, bank regulators must either close an insured depository or take other action to ensure prompt recovery.

The 1991 sanctions were increased in 1999 when Congress passed the Gramm-Leach-Bliley Act (GLBA). That statute permits only "well-capitalized" and "well-managed" firms to be financial holding companies, which are in turn the only entities allowed to engage in both banking and other, less traditional financial services. Under GLBA, a financial holding company that fails these standards is subject to immediate and harsh sanctions, including possible divestiture of non-banking activities.

Basel has long advocated adoption of the PCA framework by bank regulators outside the U.S., but progress to do this has been slow. Indeed, virtually nothing happens in most nations when a bank fails the Basel rules, even if the Basel rules have been extensively modified to be as lenient as possible – the case in Japan, for example.

The PCA framework – especially as buttressed by the GLBA sanctions – makes capital count in the U.S. This is appropriate, but it makes it even more important that U.S. regulators ensure that the Basel rules are tailored for appropriate application in the U.S. to avoid both undue competitive implications and unnecessary enforcement actions or even closings that cost the FDIC. Unless or until the PCA sanctions are adopted and enforced

in key financial services markets, U.S. regulators should not concede points in international negotiations that put U.S. banks at unique risk.

Effective, Enforced Bank Supervision Limits Arbitrage

Much in the U.S. supervisory structure noted above – especially PCA – warrants adoption by other regulators, and Basel should devote far more resources than now to improving both the quality of supervision and the enforcement to back it up. The Basel proposal rightly rests on three pillars: Pillar 1 requiring RBC, Pillar 2 mandating improved supervision and Pillar 3 stipulating increased public disclosure to promote market discipline. However, to date virtually all of the regulatory effort has gone into the Pillar 1 capital charge, in part due to the hard work necessary to craft the complex, comprehensive rule on which Basel has, I think, unwisely embarked. Pillar 2 remains in many respects a work in progress, with much of its text replete with platitudes about best practices. However, recent experience in the U.S., EU and Japan points to the critical importance of effective supervision backed up by meaningful enforcement, as well as to the relative irrelevance of international risk-based capital standards when domestic regulators choose to fudge the capital books.

A quick look at just two disputed areas in Basel II points to the critical importance of effective supervision, and the problems an excessive focus on capital can cause. One of the hottest disputes now as Basel tries to finalize the Accord is the treatment of commercial real estate (CRE). Some regulators are proposing a stiff capital charge for CRE, based on the correct perception that CRE is often a high-risk segment of a bank's loan book. Indeed, CRE played a major role in the failure of several large banks, including those in New England, during the late 1980s. However, in response to those failures, Congress required regulators to institute strict real estate lending standards that include such features as tough loan-to-value limits. These have led banks to institute prudent lending practices in this otherwise high-risk sector that have substantially limited their exposure even during this time of regional economic turmoil. A high CRE capital standard might have deterred lending essential to economic development without providing the appropriate discipline of effective supervisory standards. Clearly, in CRE – as in so many other credit-risk sectors, the balance between Pillar 1 and Pillar 2 will be essential in ensuring that Basel gets it right.

Operational risk is another area where inappropriate capital can create serious problems. The September 11 attack pointed to the indispensable importance of operational risk mitigation – disaster preparedness, contingency planning, reserves and insurance. ORBC would have had no impact on the heroic recovery after the terrorist attack, which depended on all these proven operational risk mitigants. In fact, the GAO report on critical financial infrastructure presented to the Financial Services Committee on February 12, 2003 noted that the SEC dropped its capital requirements briefly after the attack and all of the bank regulators noted that failure to comply with them would not have regulatory consequences. A focus on regulatory capital – not recovery – was clearly inappropriate.

Since the attack, regulators have struggled to issue supervisory standards on operational risk, distracted in part by the massive effort to finalize the ORBC charge. Indeed, Basel now plans not to issue final operational risk supervisory standards until year-end, deferring their effective date until the rest of Basel's rules in 2007. This delay points to the problems of pushing for a synoptic rule that tries to solve everything instead of focusing scarce regulatory resources on the most immediate, agreed-upon concerns.

Key U.S. Concerns

Above, I have noted several major concerns with the current Basel approach, including:

- the risks of unintended consequences from an over-comprehensive effort to craft global capital rules;
- the remaining risk of regulatory arbitrage, especially in areas where U.S. regulators have acceded to EU demands; and
- the critical importance of ensuring effective and enforceable supervisory standards. These exist in the U.S., making it still more important to get regulatory capital properly aligned with economic capital as determined by the market.

The complexity, arbitrage and supervisory issues raise problems for all banks covered by the Basel II rules, but they are particularly problematic for U.S. banks in several key respects. These problems may be exacerbated if U.S. regulators proceed with plans under consideration to permit only the nation's top ten banks or so to use the advanced internal ratings-based approach to credit risk under consideration at Basel.

1. Competitiveness

U.S. regulators should take care as they craft Basel II standards that the rules do not adversely affect large U.S. banks in relation to the non-banks that are key financial services competitors in this country, as well as that the rules do not adversely affect U.S. banks vis-à-vis foreign ones in those sectors in which U.S. banks now hold a global edge.

In sharp contrast to the EU, many major financial services firms in the U.S. are non-banks. Almost none of these have chosen to become financial holding companies since Congress enacted GLBA in 1999, largely due to the fact that these firms find the current bank capital rules too removed from the economic ones on which their business strategies are based. To the degree that Basel II standards impose different regulatory capital standards than economic ones, creating the regulatory arbitrage problem noted above, non-banks will remain outside the bank capital system and banks in it will operate at significant capital disadvantages, especially in sectors like asset management and payments-processing where non-banks are major competitors.

In the U.S., specialized banks can operate outside the banking charter, and some may choose to do so if the regulatory capital standards remain at odds with economic ones. This could drive key players outside the valuable supervisory framework that now protects banks and the financial system more generally.

Non-economic capital charges in key sectors also pose global competitiveness concerns. The operational risk-based capital proposal is a particular problem here, due to the major global market-share U.S. banks have in specialized businesses that will be especially hard-hit by the Basel II proposal. However, proposed standards in asset securitization could also be very costly to U.S. institutions that now lead the world in this sophisticated segment of the financial market.

2. Treatment of Smaller Banks

In 1988, U.S. regulators decided that all banks – regardless of size – should be covered by Basel I to ensure competitive equity and introduce the risk-based scheme to all banks. However, the complexity of Basel II is leading regulators to exempt from it all but the nation's very largest banks. This could have profound competitive consequences for banks left outside the Basel II framework unless so many restrictions are placed on it – the above-noted limit on deriving value from the advanced approaches, for example – that the intent of the entire Accord is deeply undermined and the value of the nearly decade-long negotiations is overturned.

As noted, the primary goal of Basel II is to end regulatory arbitrage by getting regulatory capital aligned with economic capital. This means that, assuming Basel II is fully implemented, banks with low-risk books of business will have lower RBC than is now the case. In certain lines of business – mortgages and other loans to average consumers, for example – the Basel II advanced capital numbers are far lower than those now in place. If implemented only for the largest banks, this would mean that some banks – often dominant competitors in selected markets – would have far lower regulatory capital than others in the same sector left subject to current RBC rules.

As noted, capital is a key driver of competitiveness, affecting as it does return-on-equity and other major components of overall profitability. Thus, banks not able to take advantage of the lower Basel II capital requirements will be at a profound competitive disadvantage to those banks able to reduce RBC for credit risk. This could hasten industry consolidation, leading to more product standardization and less focus on regional markets or individual customers. As numerous FDIC and other studies have shown, consolidation also concentrates increasing resources in just a few institutions, heightening potential systemic risk and damage to the deposit insurance funds.

Some U.S. regulators have suggested that this competitiveness concern is not a serious one because large and small banks don't compete. This is manifestly not the case in both major lines of business and regional banking markets all across the country. For example, exempting smaller institutions from Basel II would leave out one of the nation's largest mortgage lenders, which operates through a savings association charter. It could,

regulators argue, volunteer for Basel II to address this competitive imbalance, but its regulator — to date largely out of the overall Basel implementation process — could be unable to allow it to use Basel II or could otherwise limit its value. Similarly, it is hard to see how banks smaller than the top ten but still major competitors in their areas will be content to let the biggest banks under-cut their pricing on mortgages, small-business loans, credit-cards and many other key profit centers.

Again, a more simple approach that fixes key problems in the current capital rules would address this concern, since all but the smallest banks can and should be able to adapt their internal models to a more incremental change in RBC that reduces regulatory arbitrage without all the complexities in the current advanced sections of the proposal.

3. Cost

Both the competitiveness and small-bank issues noted above are compounded by the cost of implementing the complex rules Basel is considering in the fashion now planned by some U.S. regulators. Estimates of course vary, but a forthcoming study reportedly will suggest that Basel II systems development and implementation costs will run about \$150 million in large banks and about \$10 million in smaller ones (presuming the smaller ones are allowed to use simpler versions of Basel II).

There are no public studies of the cost of implementation to U.S. regulatory agencies, although the extent of the new rules and the qualifications for use of the advanced sections of them suggest these costs could be quite high. Increases in the assessments charged by the Comptroller of the Currency to absorb these costs could affect the cost of doing business for small national banks even if they are excluded from Basel II, while also compounding the potential cost differences for institutions with national charters that pay assessments and those regulated by the FDIC or Federal Reserve, where examination costs are borne without assessments on supervised banks.

4. Macroeconomic Impact

Other witnesses today will discuss procyclicality – that is, the concern that adjusting capital to risk will encourage lots of lending when risks are deemed low (during economic booms) and sharp curtailment in credit availability when times get tougher (busts). This is indeed a major concern in Basel II, one which regulators have sought to allay by augmenting Pillar 1 capital charges by additional "stress test" capital charges under Pillar 2. However, stress-test capital could increase potential arbitrage concerns, muting as it does the value of setting regulatory capital to economic capital in Pillar 1. Further, the comprehensive nature of the Basel II effort may exacerbate procyclicality if any of the many regulatory capital assignments proves faulty and regulatory capital incentives unduly encourage banks to make loans that then prove even riskier during economic downturns.

However, procyclicality will remain a concern even in a revised, simpler Basel II Accord. The more regulatory capital is accurately tied to risk, the greater the regulatory incentive

for low risk-taking. Pure reliance on capital – whether in Pillar 1 or through stress tests – can only allay this fear by undermining the anti-arbitrage goal at which the overall Basel rewrite is aimed. As a result, effective supervision that ensures banks do not concentrate their assets into those that appear low-risk during boom periods is an essential component of a final Basel II.